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No. 84-

IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

PENNZOIL COMPANY,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF WEST VIRGINIA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the Supreme Court of Appeals erred by upholding a decision of the Public Service Commission of West Virginia that purports to set a price for a "first sale" of natural gas in interstate commerce in violation of the intent of Congress, in excess of the authority delegated to the State of West Virginia in Section 602(a) of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3432(a), and in disregard of the previous decision of the Supreme Court of the United States in this case?

2. Whether the Supreme Court of Appeals erred by upholding a decision of the Public Service Commission of West Virginia that purports to create new federal law contrary to the intent of Congress and the specific language of Section 601(b)(1)(E) of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3431(b)(1)(E), by applying that section to a local distribution company in disregard of the fact that Section 601(b)(1)(E) is expressly applicable only to interstate pipelines?

PARTIES BELOW

The Petitioner in this case who participated in the case below is:

Pennzoil Company *

The other parties in the case below were:

Public Service Commission of West Virginia

* The following companies are the non-wholly owned subsidiaries of Pennzoil Company: National Transit Company; Pennesco, Inc.; Proven Properties, Inc.; and the Eureka Pipe Line Company.

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PENNZOIL COMPANY,

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v.

PUBLIC SERVICE COMMISSION OF WEST VIRGINIA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

Pennzoil Company (Pennzoil) petitions for a Writ of Certiorari to review a decision of the Supreme Court of Appeals of West Virginia denying Pennzoil's Appeal of an Order on Remand from this Court issued by the Public Service Commission of West Virginia (PSC) on May 15, 1984. The PSC's Order on Remand is in conflict with the intent of this Court's previous decision in this very case. Further, it erroneously decides the scope and applicability of Sections 602(a) and 601(b)(1)(E) of the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3432(a) and 3431(b)(1)(E), and exceeds the authority granted to the States by Congress in that Act. Pennzoil submits that "special and important reasons," satisfying the criteria of Sup. Ct. R. 17.1(c), justify granting a Writ of Certiorari in this case.

OPINIONS AND ORDERS BELOW

The decision of the Supreme Court of Appeals of West Virginia in *Pennzoil Co. v. Public Service Commission*, Case No. 80-175-G-42T, is unreported. That decision is

set forth in Appendix A.[1] The underlying Order of the PSC on Remand is set forth in Appendix B.

JURISDICTION

The order of the Supreme Court of Appeals of West Virginia denying Pennzoil's Appeal of the PSC's Order on Remand was entered on July 11, 1984. On September 10, 1984, Pennzoil filed with the Supreme Court of Appeals a Petition for Rehearing and Motion for Leave to Seek Rehearing.[2] The Supreme Court of Appeals entered its order denying Pennzoil's Petition and Motion on September 13, 1984. The order denying Pennzoil's Petition and Motion is set forth in Appendix C.

Pennzoil invokes the jurisdiction of this Court pursuant to 28 U.S.C. § 1257(3).

STATUTES INVOLVED

The decision of the Supreme Court of Appeals affirmed an order of the West Virginia PSC, on remand from this Court, that interpreted Sections 601(b)(1)(E) and 602(a) of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3431(b)(1)(E) and 3432(a). The relevant portions of the NGPA are set forth in Appendix D.

STATEMENT OF THE CASE

A. Introduction.

The facts of this case and the primary question presented have been before this Court once already. In

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[1] Materials included as Appendices will be cited as "App. ——."

[2] Pennzoil requested leave to seek rehearing out of time to provide the West Virginia Court with an opportunity to reconsider its decision in light of the issuance on August 22, 1984, by the Federal Energy Regulatory Commission, of Order No. 391, which clarified a controlling point of federal law. Pennzoil filed its Petition pursuant to Rule 16(b) of the Rules of Appellate Procedure of the West Virginia Supreme Court of Appeals, 21B Michie's Jurisprudence of Va. & W. Va. (Supp. 1983).

Pennzoil Co. v. Public Service Commission of West Virginia, —— U.S. ——, 103 S. Ct. 3564 (1983), this Court granted certiorari to review the previous decisions of the Supreme Court of Appeals of West Virginia and the West Virginia PSC in this case. In a memorandum decision, this Court vacated the decision of the West Virginia Supreme Court, and remanded the case for further consideration in light of this Court's decision in *Public Service Commission of New York v. Mid-Louisiana Gas Co.*, —— U.S. ——, 103 S. Ct. 3024 (1983).[3]

On remand, the West Virginia Supreme Court remanded in turn to the PSC, which took no action whatsoever for more than nine months. Then, on May 15, 1984, the PSC issued its Order on Remand, which disregards this Court's intent and effectively renders this Court's previous decision in this case a nullity.

On July 11, 1984, in a three-two decision, the Supreme Court of West Virginia upheld the PSC's Order on Remand from this Court. Unfortunately, neither the three Justices in the majority, nor the two dissenting Justices wrote an opinion explaining their reasoning.

This case presents two substantial questions of federal law that will determine the means and scope of state regulation of natural gas prices under the NGPA. The first question is whether the PSC has authority to set wellhead prices for Pennzoil's produced gas under Section 602(a) of the NGPA.[4] Pennzoil's previous Petition for Certiorari, in Case No. 81-1672, presented this Court with exactly the same issue. Although this Court's mem-

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[3] This Court's memorandum decision is set forth in Appendix E.

[4] Encompassed within the first question are two subsidiary questions: (1) whether § 602 authorizes the states to establish maximum prices for "first sales" occurring in interstate commerce; and (2) whether § 602 authorizes the states to establish maximum lawful prices on a case-by-case basis, or whether such prices may only be established by generally applicable legislation or rules issued pursuant to properly delegated authority.

orandum decision did not explain the Court's reasoning on each individual issue presented, it vacated the decision below in its entirety, rejecting both of the PSC's alternative arguments.

The second question is whether the PSC and Supreme Court of West Virginia have the authority to create new federal law by applying Section 601 of the NGPA to Pennzoil's gas operations in West Virginia. Pennzoil contends that Section 601 of the NGPA is only applicable, by its terms, to interstate pipelines in connection with rate proceedings before the Federal Energy Regulatory Commission (FERC).

The facts regarding Pennzoil's operations in West Virginia and the relevant provisions of the NGPA are described briefly below.

B. Facts.

1. *Pennzoil's Operations in West Virginia.*

Pennzoil is a producer of oil and natural gas operating approximately 2,200 wells that produce gas in West Virginia.[5] In West Virginia, Pennzoil also purchases and resells gas from approximately 140 other independent producers. To transport its own gas and gas purchased from other producers from the wellhead to interstate pipeline customers, Pennzoil operates a gas gathering system.[6] At any given time, approximately 60 percent of the gas in the gathering system has been produced by Pennzoil and approximately 40 percent has been purchased by Pennzoil from independent producers close to Pennzoil's gathering lines.

Pennzoil's primary business objective with respect to its gas production in West Virginia is to sell that gas

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[5] Pennzoil also is a producer of natural gas in 15 other states.

[6] Pennzoil's transportation of gas in its gathering system is exempt from federal regulation pursuant to § 1(b) of the Natural Gas Act. 15 U.S.C. § 717(b).

to several interstate pipelines at various points of delivery. On an average day, however, Pennzoil is permitted to sell only about 75 percent of the gas it transports in its gathering system to interstate pipelines. West Virginia law and certain orders of the PSC require Pennzoil to sell the remaining 25 percent of the gas to retail customers, located near Pennzoil's gathering lines in West Virginia, who have requested gas service. Pennzoil performs this distribution-type service through a separate division, which operates as the Utility Division of Pennzoil Company.[7] The respective volumes sold to interstate pipelines and to retail customers cannot be predicted in advance because they vary from day to day, depending on the gas requirements of the retail customers.

Historically, Pennzoil's sales of gas to interstate pipelines have been subject to federal price regulation under the Natural Gas Act as sales for resale in interstate commerce.[8] Since the passage of the NGPA, Pennzoil's wellhead sales to all purchasers have been subject to the ceiling prices established by that statute. Pennzoil's contracts with interstate pipelines are not regulated by the State of West Virginia and provide that Pennzoil will receive the applicable NGPA price.

In contrast, Pennzoil's retail sales of gas through its Utility Division, to customers required to be served under West Virginia law, are regulated by the State Public Service Commission.[9] The PSC sets Pennzoil's rates to retail customers on the basis of a typical utility "cost

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[7] The gas sold to West Virginia customers by the Utility Division is transferred by formal accounting entries from Pennzoil's production and transportation facilities to the Utility Division's distribution facilities.

[8] 15 U.S.C. § 717(b).

[9] The Commission's powers and duties are set forth in W. Va. Code §§ 24-1-1 to 24-2-16 (Supp. 1984).

of service" ratemaking methodology, which requires a calculation of Pennzoil's gas costs, taxes, administrative expenses and other factors.[10] The major component of this cost of service calculation is the cost of "purchased gas," which includes both the actual cost of gas purchased from independent producers and the imputed "cost," or value, of gas produced by Pennzoil.

Pennzoil calculates its cost of the gas it purchases from independent producers on the basis of the price it actually pays to those producers, which generally is the applicable price established by Congress in the NGPA. Similarly, in calculating the "cost" of gas Pennzoil itself produces rather than purchases, Pennzoil assigns a value to its own production equivalent to the applicable price established by Congress in the NGPA.[11]

The dispute in this case arises because the PSC has denied that the prices established by the NGPA are applicable to Pennzoil's own gas production, and has refused to utilize those prices as the starting point in determining Pennzoil's cost of service to West Virginia retail customers.

2. *The Proceedings on Remand from this Court.*

In *Public Service Commisison of New York v. Mid-Louisiana Gas Co.*,[12] this Court held that Section 2(21) of the NGPA, 15 U.S.C. § 3301(21), which determines the applicability of the prices established by the NGPA, required the application of NGPA prices to natural gas produced by interstate pipelines.[13] Due to the express

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[10] W. Va. Code § 24-1-1(a)(4) (Supp. 1984).

[11] The majority of Pennzoil's production in West Virginia qualifies for the prices provided by § 108 of the NGPA, 15 U.S.C. § 3318, and has been certified by the West Virginia Department of Mines as eligible for that price, pursuant to the procedures prescribed in § 503 of the NGPA, 15 U.S.C. § 3413, and W. Va. Code § 22-4-1a(c)(11) (Supp. 1984).

[12] 103 S. Ct. 3024 (1983).

[13] 103 S. Ct. at 3035.

inclusion of local distribution companies in the controlling language of Section 2(21), the Court's holding also established, by necessary implication, the applicability of NGPA prices to gas produced by local distribution companies such as Pennzoil. This Court remanded the *Mid-Louisiana* case to the FERC for a determination of the point at which the "first sale" under Section 2(21) would be deemed to occur, which would establish the point at which the NGPA price would be deemed to attach to pipeline and distributor production.[14]

In Pennzoil's case, which had been held in abeyance pending the decision in *Mid-Louisiana*, this Court summarily vacated the decision below and remanded for further consideration in light of *Mid-Louisiana*.[15] In turn, the West Virginia Supreme Court summarily vacated the PSC's original decision and remanded to the PSC with the same instruction. The *Mid-Louisiana* decision established conclusively that the prices prescribed by the NGPA are fully applicable to the "first sale" of Pennzoil's own production in West Virginia. Although the PSC at first denied the applicability of *Mid-Louisiana* and the NGPA to Pennzoil's gas production, the PSC finally conceded in its Order on Remand, as an initial proposition, that the prices prescribed by the NGPA do apply.[16]

In its Order on Remand, however, while superficially complying with this Court's instructions, the PSC has disregarded the necessary implications of this Court's remand, and has simply contrived new reasons to take away the very NGPA prices that the PSC itself concedes are applicable to Pennzoil's production.[17] In the Order

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[14] *Id.* at 3037.

[15] 103 S. Ct. 3564.

[16] *See* Order on Remand at 19-20; App. B at 21a-22a.

[17] The Order on Remand allows Pennzoil to price its own production at the average price Pennzoil paid for gas purchased from

on Remand, the PSC relied primarily on Section 602(a), and held:

> [T]his Commission has the authority under § 602 (a) of the NGPA to determine a just and reasonable price to be included in Pennzoil's rates for the recovery of the cost of its own production in West Virginia either by using a production cost of service study or by any other reasonable means, including a proxy for such cost of service.[18]

As an alternative rationale, without citing any legislative history or other authority, the Commission stated:

> Further, even if § 602(a) did not apply, we hold that Congress must have intended local distribution company producers such as Pennzoil to be bound by an "affiliated entities limitation" such as set out in § 601(b)(1)(E).[19]

Subsequently, Pennzoil petitioned the Supreme Court of Appeals of West Virginia to review the PSC's Order on Remand.[20] Pennzoil informed the court that the only issues in the case were whether Sections 602(a) or 601 (b)(1)(E) of the NGPA provided the PSC with authority to deny Pennzoil the NGPA price for its own produced gas.[21] On July 11, 1984, in a three-two decision, the Supreme Court of Appeals denied Pennzoil's Petition for Appeal. Without any substantive discussion, the court

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other independent producers, and reserves for the PSC the right to adopt any methodology it chooses in future cases. Order on Remand at 17-18; App. B at 19a-20a.

[18] Order on Remand at 16-17; App. B at 19a.

[19] *Id.* at 17; App. B at 19a.

[20] Pennzoil sought review in the Supreme Court of Appeals pursuant to W. Va. Code § 24-5-1 (Supp. 1984).

[21] Petition for Appeal at 6. The pleadings filed below are not included in the Appendix to this Petition, but are part of the formal Record. Because the official Record has not yet been paginated or certified, the pleadings are cited directly.

stated that it had "maturely considered" Pennzoil's Petition and the entire record and had determined that Pennzoil had not "shown itself entitled to the relief prayed for it in its said Petition." [22]

The only issues in dispute before the court were whether Sections 602 or 601 of the NGPA provided the PSC with authority to deny the applicability of NGPA prices to Pennzoil's produced gas. Therefore, to uphold the PSC's Order on Remand, the court must have relied either on the PSC's interpretation of its authority under Section 602, or on the PSC's attempted extension of federal law under Section 601.

3. *The Effect of the FERC Final Rule Implementing Mid-Louisiana.*

On August 22, 1984, the FERC issued its Order No. 391, which implements this Court's decision in *Mid-Louisiana*.[23] The critical question on remand from this Court to the FERC was the determination of the point at which the "first sale" of a pipeline's production would be deemed to occur. This Court recognized that the FERC could logically conclude that a "first sale" occurred (a) at the "intracorporate transfer" point, where pipeline production is transferred from production facilities to transmission facilities; or (b) at the downstream point at which the gas is transferred to the end-user.[24]

In Order No. 391, the FERC established that the "first sale" of production by pipelines and distribution companies occurs at the "intracompany transfer point",

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[22] Order at 1; App. A at 1a-2a.

[23] 49 Fed. Reg. 33,849 (Aug. 27, 1984). On August 29, 1984, the FERC issued minor corrections to portions of Order No. 391. Those corrections have not yet been published in the Federal Register. The relevant portions of the regulations established in Order No. 391, as corrected by the FERC, are set forth in App. F.

[24] 103 S. Ct. at 3037.

which is, in turn, defined as occurring at the wellhead.[25] In addition, after considering comments by Pennzoil and the PSC, the FERC reversed a proposed provision on which the PSC's Order had relied, and decided that its definition of the point of "first sale" at the wellhead applies uniformly throughout the United States to all gas produced by local distribution companies, such as Pennzoil, as well as to interstate pipelines.[26]

The FERC's decision is critical to this case, because it eliminates the PSC's Section 602 justification, which was the primary rationale for the PSC's Order on Remand.[27] Briefly, as explained in Part II.A below, the FERC determination that the "first sale" occurs at the wellhead establishes that, in this case, the first sale occurs "in interstate commerce." That fact is extremely significant, because it means that the price for Pennzoil's production in that "first sale", which establishes the initial "cost" or value of Pennzoil's production as the starting point for PSC ratemaking purposes, is beyond the power of the PSC to regulate under Section 602 of the NGPA.

In light of the FERC's Order No. 391, to allow the Supreme Court of Appeals an opportunity to reconsider its three-two decision denying Pennzoil's appeal, Pennzoil brought the order to the court's attention in a request for rehearing. On September 13, 1984, the Supreme Court of Appeals denied Pennzoil's Request for Rehearing without stating any explanation or legal reasoning.[28]

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[25] 49 Fed. Reg. 33,859 (1984), as corrected (to be codified at 18 C.F.R. § 270.203).

[26] The portion of the Preamble rejecting the PSC's argument appears at 49 Fed. Reg. 33,856; the final regulations are set forth in App. F.

[27] The PSC has not filed with the FERC any request for rehearing of Order No. 391, and therefore is precluded from seeking judicial review of that Order. NGPA § 506(a)(2), 15 U.S.C. § 3416(a)(2).

[28] From the brief statement provided in the Court's order, it appears that the Court did not actually consider the points raised

C. The Provisions Of The NGPA At Issue.

The NGPA extended federal price ceilings to previously unregulated intrastate sales of natural gas, and thus fundamentally altered the division of responsibility among the federal government and the States regarding regulation of natural gas prices.[29] One of the key provisions by which Congress allocated that responsibility is the primary section of the NGPA at issue in this case. That provision, Section 602(a) of the NGPA, defines the limited circumstances in which the States may override the uniform application throughout the United States of the maximum lawful prices established by the NGPA and may regulate "first sale" prices. Section 602(a) allows the States to "establish or enforce any maximum lawful price for the first sale of nautral gas produced in such State which does not exceed the applicable maximum lawful price, if any, under Subchapter I of [the NGPA]."[30]

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in Pennzoil's Request for Rehearing. The order refers to "a petition for rehearing of the Court decision remanding this proceeding to the Public Service Commission." Order at 1; App. C at 26a. That decision, however, was in a different case between Pennzoil and the PSC, Case No. 83-333-G-42T, which is scheduled for argument before the Supreme Court of West Virginia on November 7, 1984. Pennzoil's Request for Rehearing was clearly identified on its face and at numerous points in the text of the pleading as a request for rehearing in *this* case, and not in the case currently pending in West Virginia. The court's reference to the wrong case in its order denying rehearing is an indication that the court gave something less than studied consideration to the impact of the new FERC rule on its decision.

[29] *See generally Mid-Louisiana*, 103 S. Ct. 3024, 3029-34 (1983); Exxon Corp. v. Eagerton, 103 S. Ct. 2296 (1983); Energy Reserves Group v. Kansas Power & Light Co., 459 U.S. 400 (1983); Maryland v. Louisiana, 451 U.S. 725 (1981); Oklahoma v. FERC, 494 F. Supp. 636 (W.D. Okla. 1980) *aff'd*, 661 F.2d 832 (10th Cir. 1981), *cert. denied, sub nom.* Texas v. FERC, 457 U.S. 1105 (1982) (upholding the constitutionality of NGPA provisions extending federal price controls to intrastate sales of gas).

[30] 15 U.S.C. § 3432(a). Section 602 is set forth in full in App. D.

The Conference Report includes the following explanation of Section 602(a):

> The conference agreement provides that nothing in this Act shall affect the authority of any State to establish or enforce any maximum lawful price for sales of gas *in intrastate commerce* which does not exceed the applicable maximum lawful price, if any, under Title I of this Act. This authority extends to the operation of any indefinite price escalator clause. The Congress enacts this provision with a recognition that it is ceding its authority under the commerce clause of the Constitution to regulate prices for such production to affected States.[31]

If a State has properly established maximum lawful prices pursuant to the authority granted by Section 602(a), then those prices supplant the applicable NGPA prices, for sales of gas in *intrastate* commerce. This case presents the issues of what producer sales the States may regulate, and how the States may exercise their authority under Section 602(a).

The second provision at issue in this case, Section 601(b)(1)(E), establishes a test called the "affiliated entities limitation." The specific language of Section 601(b)(1)(E) provides that, in a rate proceeding under Sections 4 or 5 of the Natural Gas Act,[32] the price paid by an interstate pipeline for gas purchased from an affiliate of that pipeline is presumed to be "just and reasonable", and therefore may be collected in the interstate pipeline's rates, if the amount paid "does not exceed the amount paid in comparable first sales between persons not affiliated with such interstate pipeline." Pennzoil is not an interstate pipeline, and is not subject to regulation under Sections 4 and 5 of the Natural Gas Act, but rather falls within the classification

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[31] H.R. Rep. No. 1752, 95th Cong., 2d Sess. 124-25, *reprinted in* 1978 U.S. Code Cong. & Ad. News 8983, 9041 (emphasis added).

[32] 15 U.S.C. §§ 717c & 717d.

of a local distribution company under the NGPA. 15 U.S.C. § 3301(17). Therefore, the PSC's Order on Remand applying Section 601 to Pennzoil requires a determination of whether, and if so how, Section 601(b)(1)(E) may be applied to intrastate entities in state regulatory proceedings.

REASONS FOR GRANTING THE WRIT

Pennzoil seeks a Writ of Certiorari for three reasons: 1) to obtain an order from this Court instructing the West Virginia Supreme Court and the PSC to comply with the necessary implication of this Court's prior decision in this case; 2) to obtain review of the PSC's unlawful application of Section 602(a) of the NGPA; and 3) to obtain review of the PSC's usurpation of the power to write federal law in its extension of Section 601(b)(1)(E) of the NGPA to Pennzoil's operations. The latter two issues are substantial questions of federal law, and are of nationwide impact and significance in establishing the dividing line between federal and state authority in regulating sales of natural gas.

I. THE PSC HAS DISREGARDED THE INTENT OF THIS COURT'S PREVIOUS DECISION IN THIS CASE.

The PSC's Order on Remand and the decision of the Supreme Court of Appeals in this case were entered after a remand from this Court in *Pennzoil Co. v. Public Service Commission of West Virginia*, —— U.S. ——, 103 S. Ct. 3564 (1983). In that case, as now, Pennzoil had asserted the right to apply the prices established by Congress in the NGPA as the starting point in calculating rates applicable to the portion of Pennzoil's production sold to retail customers in West Virginia. The PSC argued to this Court that the NGPA did not apply to natural gas produced by local distribution companies such as Pennzoil. As a secondary position, the PSC argued to this Court that even if the NGPA were appli-

cable, Section 602(a) of the NGPA provided the PSC with the authority to set a price for Pennzoil's production lower than the NGPA price.

This Court's decision in *Mid-Louisiana* eliminated the PSC's first argument, and provided the basis for this Court's memorandum decision vacating the judgment below and remanding this case to the Supreme Court of West Virginia. Although the PSC's Order on Remand concedes that this Court's decision in *Mid-Louisiana* is applicable to Pennzoil's situation in West Virginia, and concedes that the prices established by Congress in the NGPA are applicable to Pennzoil's natural gas production in West Virginia, the PSC still denies Pennzoil the NGPA prices that this Court's *Mid-Louisiana* decision found to be applicable.

The PSC relies primarily on the interpretation of Section 602 of the NGPA that it offered as its fall-back argument to this Court in this case in 1982. The PSC's Section 602 argument was squarely before this Court at that time, and despite that argument, this Court's memorandum decision vacated the decision of the court below in its entirety. Therefore, the necessary implication of this Court's prior decision is that the PSC's Section 602 argument is without merit. The decisions of the PSC and the Supreme Court of West Virginia on remand from this Court have ignored that necessary implication.

In addition, the order of the West Virginia Supreme Court denying Pennzoil's Appeal does not make any attempt to comply with this Court's instruction to reconsider Pennzoil's case in light of *Mid-Louisiana*. The West Virginia court's order makes no mention of *Mid-Louisiana*, or of any other case or legal rationale, and merely states that the court "maturely considered" the case. In fact, the language of the order denying Pennzoil's appeal on remand is almost identical to the language of the court's order four years ago, denying Pennzoil's original appeal in this case. The only significant

difference is that the two dissenting Justices now appear to be persuaded of the correctness of Pennzoil's position.

At a minimum, the order from this Court remanding with instructions to the court below imposed a duty on that court to reconsider the vacated decision fairly and to provide some reasoned explanation for the decision on remand. The order of the West Virginia Supreme Court provides no explanation at all, and ignores this Court's direction on remand. Therefore, the order should at least be vacated and remanded for further explanation.

II. THE PSC HAS EXCEEDED THE AUTHORITY GRANTED TO THE STATES BY CONGRESS.

The primary question presented by this case is whether the PSC has the authority to refuse to recognize the NGPA price applicable at the point of the "first sale" and to set its own wellhead price for Pennzoil's produced gas. The PSC asserts that Section 602(a) of the NGPA authorizes it to set maximum lawful prices for "first sales" of gas produced in West Virginia. However, the PSC's Order on Remand misinterprets Section 602(a) and exceeds the powers delegated to the States by Congress in the NGPA.

The PSC has exceeded its authority in three ways. First, the authority delegated under Section 602(a) only allows the states to establish maximum lawful prices for sales of gas in "intrastate" commerce. In this case, the "first sale" of Pennzoil's produced gas takes place in "interstate" commerce, and is beyond the regulatory power of the State. Second, under Section 602(a), only the Legislature, and not the PSC, has the authority to establish maximum lawful prices for wellhead sales. In this case, the Legislature has neither exercised that power nor delegated that power to the PSC. Third, the authority under Section 602(a) to establish a "maximum lawful price" for "first sales" of natural gas may not be exercised on a case-by-case basis. Rather, it may only

be exercised through the enactment of legislation or through the establishment, pursuant to properly delegated authority, of general rules applicable to all wellhead sales in the State.

A. Pennzoil's First Sale Is Not In Intrastate Commerce.

Under Section 602(a), the States only have power to establish maximum lawful prices for first sales in "intrastate" commerce.[33] As established by the FERC Final Rule implementing this Court's decision in *Mid-Louisiana*, the "first sale" of Pennzoil's produced gas takes place at the wellhead, when that gas is transferred from Pennzoil's production facilities to its transportation or distribution facilities.[34] As a result, as explained below, the "first sale" of Pennzoil's gas takes place in "interstate" and not "intrastate" commerce.

The majority of Pennzoil's produced gas is sold to interstate pipelines for resale in interstate commerce, while the remaining produced gas is sold to retail customers in West Virginia. At the wellhead, the point of the "first sale," gas destined for interstate commerce is commingled with gas that ultimately will be sold to retail customers in West Virginia, and it is impossible to determine which molecules of gas ultimately will flow to particular interstate or intrastate customers. Prior decisions of this Court and lower courts regarding the effects of commingling gas destined for interstate customers with gas destined for intrastate customers establish beyond doubt that the "first sale" at the wellhead of the entire volume of Pennzoil's produced gas takes place in "interstate" commerce, and not in "intrastate" commerce.[35]

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[33] H.R. Rep. No. 1752, 95th Cong., 2d Sess. 124, *reprinted in* 1978 U.S. Code Cong. & Ad. News 8983, 9041.

[34] 49 Fed. Reg. at 38,859; App. F at 31a.

[35] California v. Lo-Vaca Gathering Co., 379 U.S. 366 (1965); FPC v. Amerada Petroleum Corp., 379 U.S. 687 (1965); Public Service Comm'n of Kentucky v. FERC, 610 F.2d 439, 444 (6th Cir.

Because the "first sale" of Pennzoil's produced gas is in "interstate" and not "intrastate" commerce, the "first sale" at the wellhead is exempt from Section 602(a) and the PSC has no power to set a price for Pennzoil's production at that point that is lower than the applicable NGPA price. In setting utility rates for Pennzoil's retail sales to West Virginia customers, the NGPA preempts the PSC's ability to alter the "first sale" price applicable to Pennzoil's production.[36] The PSC therefore is obligated by federal law to recognize the applicable NGPA price as the "cost" of Pennzoil's produced gas for purposes of determining the "gas cost" component of Pennzoil's rates.

In *Mid-Louisiana Gas Co. v. FERC*, 664 F.2d 530 (5th Cir. 1981), the U.S. Court of Appeals for the Fifth Circuit addressed precisely this concept. With respect to state regulation of retail sales, the Fifth Circuit stated:

> [I]f the NGPA prices attached to the intracorporate transfer by the producer then the state's jurisdiction over retail sales would remain intact. The only change would be that *the cost of the gas to the*

1979); Louisiana Public Service Comm'n v. FPC, 359 F.2d 525 (5th Cir.), *cert. denied*, 385 U.S. 833 (1966); Deep South Oil Co. v. FPC, 247 F.2d 882 (5th Cir. 1957). The decisions in *Public Service Comm'n of Kentucky* and *Deep South* are particularly relevant, because the fact situations in those cases are very similar to the fact situation in this case.

[36] Pennzoil Co. v. FERC, 645 F.2d 360, 385-87 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982) (recognizing possible preemption of state law by federal common law "when the issues involve so strong a federal interest that it is appropriate to resolve them on the basis of uniform decisional federal law rather than varying state laws"). *See* California v. Southland Royalty Co., 436 U.S. 519 (1978) (holding that federal interests under Natural Gas Act override state property law on issue of dedication to interstate commerce); United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392, 400 (1965) (finding proper interpretation of term "sale" under Natural Gas Act must be determined pursuant to federal law and not state law).

> *pipeline or distribution company would be the NGPA price.* Jurisdiction to set the final retail charge would remain with the state. *Although the retail price would reflect the NGPA cost of gas,* that change is consistent with Congress' desire to establish a uniform price for producers of both intrastate and interstate gas.[37]

Thus, under the NGPA, the PSC retains the right to determine the extent to which Pennzoil will be permitted to recoup in its rates the additional costs of serving retail customers, such as administrative expenses, distribution expenses and taxes. However, the PSC cannot deny Pennzoil the right to include in its rates the true value of its production, as allowed under the NGPA.

B. The West Virginia Legislature Has Chosen Not To Exercise Its Authority Under Section 602.

Even if the "first sale" of Pennzoil's produced gas were in intrastate commerce, the PSC still would have no power to set the price of that transaction. Section 602(a) provides that the NGPA does not preempt State pricing laws regarding first sales in intrastate commerce, but it does not expand the existing powers of the States, and it is not an independent source of authority to regulate wellhead prices. In West Virginia, the PSC had no power under state law, before the NGPA, to regulate the price of wellhead sales by producers,[38] and, in fact, never

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[37] 664 F.2d at 537 (emphasis added).

[38] *Cf.* Eureka Pipe Line Co. v. Public Service Comm'n, 148 W. Va. 674, 684, 137 S.E.2d 200, 206 (W. Va. 1964) (holding no power to regulate oil production or marketing). The jurisdiction of the Public Service Commission with respect to natural gas extends only to utilities engaged in "transportation of . . . gas . . . by pipeline [and] . . . supplying . . . gas . . . by municipalities or others." W. Va. Code § 24-2-1 (Supp. 1984). In its function as a producer of natural gas, Pennzoil Company is not a public utility. The Commission's jurisdiction extends only to the sale of gas by Pennzoil's Utility Division to retail customers.

has attempted to do so, except in this case. Nothing in the NGPA gives it the power to regulate those sales now, absent authorization by the West Virginia Legislature.

In Section 602(a), Congress ceded its power to regulate prices for first sales in intrastate commerce to the "States" and not to state agencies. The NGPA contains a precise definition of the term "State", which does not include any reference to state agencies.[39] In other sections of the NGPA, Congress delegated powers to the state agency itself, and not by using the term "State."[40] In view of the NGPA's specific definition of the term "State," the delegation of authority in Section 602(a) must be viewed as a delegation to state legislatures rather than to state agencies. Therefore, the PSC has no power to implement Section 602(a) unless that power has been properly delegated to the Commission by the West Virginia Legislature.

In the six years since the effective date of Section 602 (a), the West Virginia Legislature has chosen not to enact any statute establishing maximum lawful prices for "first sales" in intrastate commerce.[41] Further, the Legislature has chosen not to delegate any authority to the PSC to regulate wellhead sales under Section 602(a) of the NGPA.[42] Thus, in this case, the Commission's reg-

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[39] The NGPA defines the term "State" as "each of the several States and the District of Columbia." 15 U.S.C. § 3301(34).

[40] *See, e.g.*, § 503, 15 U.S.C. § 3413.

[41] The enactment of such a statute would be detrimental to, and most certainly opposed by, thousands of small producers and royalty owners who operate, and vote, in West Virginia.

[42] The Legislature has stated that "the Commission shall carry out other federal acts, including appropriate portions of the 'Natural Gas Policy Act of 1978,' for which the governor designates it as the responsible agency in this State." W. Va. Code § 24-2-13 (1980). That provision does not expand the Commission's existing jurisdiction, which does not extend to regulation of wellhead prices. In addition, the Governor of West Virginia has not designated the PSC as the responsible agency for any purposes under the NGPA.

ulation of Pennzoil's "first sale" price not only exceeds the authority delegated by Congress under Section 602 (a), but also exceeds the authority delegated to the PSC by the West Virginia Legislature, and violates the NGPA's allocation of powers between the federal and state governments.

C. Section 602 Precludes Establishment Of Rates On A Case-By-Case Basis.

Finally, even if it is deemed to have authority to set wellhead prices, the PSC has no power under Section 602(a) of the NGPA to regulate the "first sale" price for Pennzoil's production on a case-by-case basis in a retail rate proceeding. If Congress had intended to allow the States to set "first sale" prices in individual cases, using a "cost of service" methodology, it would have expressly stated that the States could set "just and reasonable" prices, rather than "maximum lawful" prices.

In Section 602(a) of the NGPA, Congress authorized the States to set "maximum lawful" prices lower than the applicable maximum prices established by the NGPA.[43] Before the NGPA, under the Natural Gas Act, the FERC had established "just and reasonable" prices for producer sales of natural gas in interstate commerce relying primarily on a cost of service ratemaking methodology. The NGPA concept of "maximum lawful price" was intended to replace the cost-based "just and reasonable" prices, that had existed under the Natural Gas Act, with uniform statutory prices based in large part on the level of incentive Congress deemed necessary to elicit new gas supplies.[44]

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[43] 15 U.S.C. § 3432(a).

[44] *See generally* Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101, 106-21 (1980) for an ex-

In the NGPA, Congress put an end to "cost of service" ratemaking for producers of natural gas at the federal level by establishing categories of uniform "maximum lawful prices" applicable to all "first sales" of gas in the United States. Thus, when it used the term "maximum lawful price" in Section 602(a), Congress intended only to authorize the States to establish generally applicable categories of ceiling prices for "first sales" in intrastate commerce.[45] In *Mid-Louisiana*, this Court implicitly recognized that interpretation, stating that Section 602(a) "allows the states to establish *price ceilings* . . . lower than the *federal ceiling*."[46]

In West Virginia, the Legislature may enact a statutory plan of uniform maximum lawful price ceilings under the authority of Section 602(a), or it may, by statute, delegate to the PSC the authority to establish uniform maximum prices by regulation. In no circumstance, however, does the Commission have the power to implement Section 602(a) on a case-by-case basis, effectively setting wellhead prices only for some producers, who happen also to perform a public service by selling gas to retail customers.

When it enacted Section 602(a), Congress must have been aware of the existence of the New Mexico Natural Gas Pricing Act, which had been enacted by the New

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planation of the cost-based "just and reasonable" ratemaking methodology under the Natural Gas Act and a comparison with the system of maximum lawful prices established by the NGPA.

[45] Congress used the term "maximum lawful price" throughout the NGPA when referring to the general categories of prices applicable to all "first sales" of gas.

[46] 103 S. Ct. 3024, 3036 n.20 (emphasis added). *See also* Exxon Corp. v. Eagerton, 103 S. Ct. 2296, 2303 (1983) (States may "establish *a price ceiling* for intrastate producer sales of gas at a level lower than the federal ceiling.") (emphasis added).

Mexico Legislature in 1977.[47] In that statute, New Mexico established a ceiling price for all sales of gas produced in New Mexico and sold in intrastate commerce, subject to certain limitations and escalations.[48] Since the effective date of Section 602, two states have joined New Mexico in enacting statutes establishing maximum lawful prices for sales in intrastate commerce.[49] The only logical construction of Section 602(a) is that Congress intended to allow the States to establish uniform ceiling prices by statute. The outcome of this case will determine the manner in which the remaining 47 states implement Section 602.

D. Potential Consequences Of The Commission's Assertion Of Authority.

The PSC's assertion of authority to set wellhead prices under Section 602(a) is totally unfounded, and the decision of the Supreme Court of Appeals upholding the Commission's action is in error. Unless this error is corrected, the purposes of the NGPA will be seriously undermined. In addition, the PSC's usurpation of authority to set wellhead prices under Section 602(a) will have significant practical consequences for all producers of natural gas in West Virginia and in other States that follow West Virginia's example.

The interpretation of Section 602(a) adopted by the PSC would allow State public service commissions to

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[47] N.M. Stat. Ann. §§ 62-7-1 to 62-7-10 (1978) (repealed Supp. 1984). Senator Domenici of New Mexico was one of the nine managers of the Conference on the NGPA on the part of the Senate.

[48] *See* Hecht Co. v. Southern Union Co., 474 F. Supp. 1022, 1029-30 (D.N.M. 1979).

[49] Kansas Natural Gas Price Protection Act, Kan. Stat. Ann. §§ 55-1401 to 1415 (1983); Oklahoma Natural Gas Price Protection Act, 52 Okla. Stat. Ann. §§ 260.1 to 260.13 (Supp. 1983). The legislative history of the Kansas Act specifically references the authority granted to the states by the NGPA. Committee Report on H.B. 2680, Kansas Journal of the House at 962 (1979).

regulate wellhead gas prices without authorization from their State legislatures. Nothing in the provisions or history of the NGPA suggests in any way that Congress intended Section 602(a) to authorize State commissions to regulate wellhead prices without State statutory authorization. In addition, if State public service commissions may establish the maximum lawful prices referred to in Section 602(a) on a case-by-case, cost-of-service basis, there will be as many "maximum lawful prices" as there are wells within the State. Production from each well could receive a different cost-based price, depending on the particular circumstances of that well.

In West Virginia alone, the burden of case-by-case regulation of "first sales" in intrastate commerce would be enormous. In West Virginia, there presently exist more than 40,000 producing oil and gas wells from which sales of gas are or may someday be made within the State. In addition to the regulatory burden the PSC's interpretation would impose on West Virginia producers, the PSC itself would be faced with the immense task of conducting cost-of-service rate proceedings for every individual producer sale and establishing a "maximum lawful rate" for each of those sales. Every producer rate decision would be subject to judicial review.

In summary, the interpretation adopted by the PSC and upheld by the Supreme Court of Appeals would begin anew the same type of revolution in natural gas price regulation in the States that this Court's decision in *Phillips Petroleum Co. v. Wisconsin*[50] began at the federal level. In view of the long experience, and extreme difficulty, of the Federal Power Commission in implementing the *Phillips* decision through case-by-case producer price regulation,[51] and in view of the fact that one

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[50] 347 U.S. 672 (1954).

[51] *See In re* Permian Basin Area Rate Cases, 390 U.S. 747, 755-58 (1968).

of the purposes of the NGPA was to relieve that difficulty by eliminating cost-based regulation of producer prices, the PSC's interpretation requiring case-by-case, cost-of-service regulation of "first sales" cannot be correct. As this Court held in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, "Congress explicitly envisioned that the states would regulate intrastate markets in accordance with the overall national policy."[52] The PSC's case-by-case approach to producer pricing is contrary to national policy, as enunciated by Congress in the NGPA, and must be struck down.

III. THE PSC HAS ATTEMPTED TO CREATE NEW FEDERAL LAW.

The PSC's fall-back argument is that Section 601(b)(1)(E) of the NGPA, which establishes an "affiliated entities limitation" applicable to interstate pipelines, also is applicable to local distribution companies, and that Section 601 therefore gives the PSC the power to deny Pennzoil the prices established by the NGPA. In its Order on Remand, the PSC summarizes its Section 601 argument in Conclusion No. 5 of its Conclusions of Law, stating:

> Just as Congress undoubtedly intended pipeline producers to be treated in the same manner as pipeline affiliate producers, by making any intracorporate transfers subject to the "affiliated transaction limitation" test in § 601(b)(1)(E), so too must Congress have intended local distribution company producers to be treated in a similar manner. *Mid-Louisiana*, 103 S. Ct. at 3036.[53]

Neither the language of the NGPA nor this Court's decision in *Mid-Louisiana* provides any support for that statement.

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[52] 459 U.S. 400, 420-21 (1983).

[53] Commission Order on Remand at 21; App. B at 22a-23a.

The primary shortcoming of the PSC's argument is that the words of Section 601 itself specifically negate any congressional intent to apply Section 601 to local distribution companies. The Order on Remand fails to mention that the "affiliated entities limitation" set forth in Section 601(b)(1)(E) specifically states that it is applicable "[f]or purposes of" the paragraph of the NGPA in which it appears. Each of the other subsections of that paragraph, to which the affiliated entities limitation is applicable, is operative "for purposes of Sections 4 and 5 of the Natural Gas Act." *See* § 601(b)(1)(A), (B), (C), (D). Because Congress specifically limited the applicability of Section 601(b)(1) to proceedings under Sections 4 and 5 of the Natural Gas Act, it is simply impossible that Congress could have intended those provisions to be applicable to local distribution companies. As Congress well knew, *none* of the provisions of the Natural Gas Act apply to "the local distribution of natural gas or to the facilities used for such distribution." [54]

If that is not enough, the Commission's Order further ignores the specific language of Section 601(b)(1)(E) which states that it applies to first sales between an "*interstate pipeline*" and an affiliate.[55] The Conference Report on the NGPA similarly refers only to transactions between an "*interstate pipeline*" and an affiliate, and makes no mention anywhere of any similar test applicable to local distribution companies.[56] Thus, there is no evidence anywhere in the NGPA or its legislative history that Congress intended any portion of Section 601(b) to be applicable to any entities except interstate pipelines, and the PSC's attempt to extend that section to local distribution companies is manufactured from thin air.

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[54] Natural Gas Act § 1(b), 15 U.S.C. § 717(b).

[55] 15 U.S.C. § 3431(b)(1)(E) (emphasis added).

[56] H.R. Rep. No. 1752, 95th Cong., 2d Sess. 124 *reprinted in* 1978 U.S. Code Cong. & Ad. News 8983, 9040 (emphasis added).

In its Section 601 argument, the PSC has attempted to take away the prices the NGPA grants, despite the fact that the PSC's sister agency, the Oil & Gas Division of the West Virginia Department of Mines, has expressly confirmed and certified to the FERC the proper NGPA price for each of Pennzoil's producing wells. Instead of allowing Pennzoil to price its production according to the NGPA category for which each of Pennzoil's specific wells qualifies, the PSC's Order on Remand bases the price for Pennzoil's production on the price other, unrelated, producers collect for gas produced from entirely separate wells, in different areas, under different conditions. Instead of permitting Pennzoil to collect the value of *its own* gas as established in the NGPA, the Commission has attempted to limit Pennzoil to the value of *someone else's* gas, which may qualify for entirely different pricing categories under the NGPA. That "reasoning" is both illogical and contrary to federal law.

Finally, if this Court were to allow the PSC to create new federal law by extending Section 601 of the NGPA to local distribution companies, then it would be necessary to decide the question of whether the PSC also has the power to impose its own interpretation of the affiliated entities limitation. The interpretation set forth in the Order on Remand ignores the fact that the gas Pennzoil purchases in numerous transactions with independent producers is made up of volumes produced from hundreds of individual wells, each of which qualifies for a distinct NGPA price. Similarly, Pennzoil's own production is a composite of volumes produced under several different NGPA price categories. Thus, even if the affiliated entities test of the NGPA were applicable, the only proper interpretation of that test would require a comparison of Pennzoil's actual purchase prices from independent producers within each NGPA price category with the imputed "cost" of Pennzoil's own production qualifying in each corresponding price category.

If the affiliated entities limitation of the NGPA were deemed to be applicable to Pennzoil's production in West Virginia, it is clear that the technical application of that test would be an enormously complicated task. It is similarly clear that the Commission's Order gives no meaningful direction and sets no permanent standards for applying that test in Pennzoil's case.[57] In these circumstances, the Commission's unsupported and undefined "affiliated entities limitation" cannot provide a sufficient basis for the Commission's decision to deny Pennzoil the NGPA prices for which this Court and the FERC have determined its production qualifies.

CONCLUSION

The questions presented by this case are of national importance, affecting every producer who sells gas subject to State regulation, and affecting the powers and duties of every State legislature and State regulatory commission. Unless this Court resolves the questions presented, the proper application of the NGPA to thousands of transactions nationwide will be uncertain. Therefore, Pennzoil respectfully requests this Court to grant a Writ of Certiorari.

Respectfully submitted,

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Dated: October 9, 1984

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[57] Indeed, the Order on Remand implies that in future cases it may apply totally different standards. *See* Order on Remand at 18; App. B at 20a.

APPENDICES

APPENDIX A

STATE OF WEST VIRGINIA

At a Regular Term of the Supreme Court of Appeals continued and held at Charleston, Kanawha County, on the 11th day of July, 1984, the following order was made and entered, to-wit:

80-175-G-42T

PENNZOIL COMPANY, a corporation

vs.

PUBLIC SERVICE COMMISSION OF WEST VIRGINIA

Upon an appeal from, suspension and review of the final order of the Public Service Commission of West Virginia made and entered on May 15, 1984.

The Court having maturely considered the petition and exhibits; the motion to consolidate, motion for expedited argument and decision, and conditional renewal of motion to collect rates subject to bond; note of argument on behalf of intervenor the Consumer Advicate [*sic*] Division of the Public Service Commission of West Virginia in response to Pennzoil Company's motion aforesaid; response of the Public Service Commission of West Virginia to the aforesaid motion; the record consisting of all papers, documents and evidence which were before the Public Service Commission at the hearing which resulted in the entry of the final order complained of; the statement of reasons for the entry of its order of May 15, 1984, filed herein by the respondent, Public Service Commission of West Virginia on July 5, 1984, and the oral argument of counsel on the date fixed by the Court for hearing upon

the aforesaid petition; a majority of the Court is of opinion that the petitioner has not shown itself entitled to the relief prayed for in its said petition. It is therefore considered and ordered that the prayer of the petition for an appeal from, suspension and review, in this proceeding, be, and the same is hereby denied.

It is further ordered that leave be, and the same is hereby granted to the Public Service Commission of West Virginia to withdraw from the office of the Clerk of this Court, the record consisting of all papers, documents and evidence originally filed with the Public Service Commission of West Virginia. Chief Justice McHugh and Justice Neely would grant.

A True Copy

Attest: /s/ George W. Singleton
Clerk Supreme Court of Appeals

APPENDIX B

PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA
CHARLESTON

At a session of the PUBLIC SERVICE COMMISSION OF WEST VIRGINIA, at the Capitol in the City of Charleston on the 15th day of May, 1984.

Case No. 80-175-G-42T

PENNZOIL COMPANY, a corporation,
Vienna, Wood County.
In the matter of increased
rates and charges.

COMMISSION ORDER ON REMAND FROM THE UNITED STATES SUPREME COURT

PROCEDURE

On May 1, 1980, Pennzoil Company, a corporation, filed a new tariff designated Fifth Revised Sheet No. 14, superseding Fourth Revision of Original Sheet No. 14, P.S.C. W. Va. No. 1, stating increased rates and charges of approximately $1.98 million for providing natural gas service to approximately 5,400 customers in Boone, Calhoun, Cabell, Clay, Doddridge, Gilmer, Harrison, Kanawha, Lewis, Lincoln, Logan, Marion, Marshall, Monongalia, Pleasants, Putnam, Ritchie, Roane, Tyler, Wetzel, Wirt and Wood Counties, to become effective on June 10, 1980. The filing included Pennzoil's request for $3.31/Mcf for the cost of its own gas production.

By Order entered on June 2, 1980, Pennzoil Company (Pennzoil or Company) was made Respondent to this proceeding and pending investigation, hearing and decision thereon, the aforesaid new tariff was suspended and the use of the rates and charges stated therein deferred until October 8, 1980, unless otherwise ordered by the Commission. It was further ordered that if the case had not been finally decided at the expiration of the aforesaid suspension period, such rates and charges as applied for could not be placed into effect until the Respondent entered into a bond with surety approved by the Commission in the amount of $1.98 million, conditioned for the refund to the persons or parties entitled thereto of the amount of the excess, if any, plus interest thereon.

On October 30, 1980, Pennzoil filed a Statutory Bond with the Commission in the amount of $1.98 million as required by the Commission's June 2, 1980 Order prior to the implementation of rates.

On February 17, 1981, a Commission Hearing Examiner entered a decision in this case approving a $230,848 increase in rates and charges. The Examiner's Decision included a determination that a price of $1.3945 per Mcf[1] was just, reasonable and the appropriate amount to include in cost of service to reflect the cost of Pennzoil's own gas production.

On March 4, 1981, Pennzoil filed Exceptions to the Hearing Examiner's Decision alleging that such Decision

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[1] Production Cost — $ .6785
Gathering Cost — .6100
Total $1.2885

B&O tax on gas production at 8.63% — $ .1060
Total $1.3945

deprived it of a proper treatment of its cost for its own gas production. Oral argument was held on April 28, 1981 and on September 10, 1981, the Commission entered an "Order Modifying the Hearing Examiner's Decision". The Commission approved a $847,532 increase in rates and charges which included a determination that a just and reasonable price for the Company's own gas production was $1.773 per Mcf.[2] The production cost component of such price was calculated by adjusting the 65.14¢ per Mcf IOGA rate, adopted by the Commission in Case No. 9025 for Pennzoil, by 155 percent, the cumulative GNP price deflator index for the period June 1976, through June, 1982. To such amount the Commission added a 61¢ per Mcf gathering cost and the B&O tax levied by the State of West Virginia on gas production to arrive at the $1.773 price per Mcf. Although the Hearing Examiner discussed several grounds upon which to base his decision in pricing Pennzoil's gas production, the Commission was of the opinion that the Examiner's discussion of the "first sale" requirements of the Natural Gas Policy Act of 1978 (NGPA), as interpreted by the Federal Energy Regulatory Commission (FERC) in Order 58, was a sufficient legal ground upon which to find inappropriate Pennzoil Company's claim for $3.31, the price at which it sold its gas to its various wholesale purchasers. The Commission determined that the $3.31 price, which the Company collected under bond subject to re-

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[2] Production Cost — $1.01 (65.14 cents × 1.55 = 100.967 cents)
Gathering Cost — $ .61
Total $1.62

B&O tax on gas production at
8.63% — $ .153
Total $1.773

(Order Modifying Hearing Examiner's Decision, September 10, 1981, p. 17).

fund in this case from October of 1980 to October of 1982 when the rates in its subsequent rate case became effective, could not be applied to Pennzoil's gas production because such quantities of gas did not qualify as a "first sale" as required by the definition thereof contained in the NGPA, Section 2(21) 925 Stat. 3355, 15 U.S.C. § 3301(21); 18 CFR § 270.203 (1982).

Pennzoil appealed the Commission's September 10, 1981 Commission Decision to the West Virginia Supreme Court of Appeals, which, by order entered December 10, 1981, denied the appeal. By a subsequent order entered on December 22, 1981, the West Virginia Supreme Court of Appeals granted the Company's Petition for a Stay of the Commission's Decision until March 10, 1982, or until such time as Pennzoil's application to the United States Supreme Court was finally determined.

On July 6, 1983, the United States Supreme Court entered an order vacating the West Virginia Supreme Court of Appeals judgment and remanding the same to the Supreme Court of Appeals of West Virginia for further consideration in light of *Public Service Commission of the State of New York v. Mid-Louisiana Gas Company*, 463 U.S. ——; 103 S.Ct. 3024 (1983). By Order entered on September 7, 1983, the West Virginia Supreme Court of Appeals certified the remand from the United States Supreme Court to the Public Services Commission.

This case is similar to *Mid-Louisiana* in that (1) it involves the appropriate pricing of a regulated entity's own gas production; (2) it involves the appropriate treatment of an intracorporate transfer within a private corporation; and (3) the NGPA does not speak directly to either situation. However, *Mid-Louisiana* is different in at least two respects from *Pennzoil*. First, Pennzoil is an intrastate local distribution company operated by a producer of oil and gas, whereas the producer in *Mid-Louisiana* is an interstate pipeline company. Second, Congress included § 602(a) in the NGPA authorizing States to es-

tablish and enforce any maximum lawful price for the first sale of natural gas in such state which does not exceed the applicable maximum lawful price, if any, under Title I of such Act.

ISSUE

What is the appropriate rate for Pennzoil to recover in its cost of service for its own produced gas in light of the United States Supreme Court Decision in *Public Service Commission of the State of New York v. Mid-Louisiana Gas Company, supra.*

DISCUSSION

A. *Summary of U.S. Supreme Court Decision in Mid-Louisiana*

The question presented to the Supreme Court in *Mid-Louisiana* was whether the FERC had the authority to exclude from the scheme of pricing established in the NGPA most of the gas produced from wells owned by interstate pipelines and to prescribe a different method of setting prices for that gas. The answer was provided to the Court by the NGPA's definition of a "first sale" and by the scheme of the entire NGPA.

On November 14, 1979, the FERC adopted in its Order No. 58 its final regulations with regard to Section 270.203 of Part 270, Subchapter H, Chapter I, Title 18, of the Code of Federal Regulations entitled "Pipeline, Distributor and Affiliate Production." In § 270.203(a), the FERC adopted an attribution rule for pipelines and distributors for the purpose of applying § 2(21)(B) of the NGPA. Such regulation provided that a sale of its own produced gas by a pipeline or distributor is a first sale to the extent that such sale was comprised *exclusively* of production volumes of natural gas from identifiable wells, properties, or reservoirs which are owned by such pipeline or distributor. FERC Order No. 58 clearly stated that "mixed volume sales by a pipeline or distribu-

tor are not considered to be first sales under the attribution rule" (April 28, 1981, Tr., p. 80). Thus, Order No. 58 left most interstate pipeline production outside NGPA coverage because so much of such production was commingled with purchased gas.

On August 4, 1980, the FERC entered Order No. 98, asserting jurisdiction over such production and its downstream sale under the Natural Gas Act (NGA), 52 Stat. 821, 15 U.S.C. § 717 *et seq.* The FERC concluded that such mixed pipeline production should be treated in a manner comparable to that given independent production under the NGPA. The FERC accorded NGPA first sale pricing to all pipeline production, but limited such treatment to leases acquired subsequent to October 8, 1969, and to all pipeline production from wells drilled after January 1, 1973, regardless of when the underlying lease had been acquired. The remainder of pipeline production would be regulated under the provisions of the NGA.

Pipeline producers first sought review of Order No. 58 in the U.S. Court of Appeals for the Fifth Circuit, which held that the NGPA was intended to provide the same incentives for pipeline production as for independent production. The Court of Appeals found that the FERC's reading of the NGPA was inconsistent with the goals of Congress and that there existed no practical obstacles to treating the transfer of gas from a pipeline's production division to its transportation division as a first sale. *Mid-Louisiana Gas Co. v. Federal Energy Regulatory Commission*, 664 F.2d 530 (5th Cir. 1981).

The FERC and several state regulatory commissions filed Petitions for Certiorari contending that the Court of Appeals' decision would provide the pipelines with windfall profits that Congress did not intend. The Court granted Certiorari. *Public Service Commission of the State of New York v. Mid-Louisiana Gas Company*, —— U.S. ——, 103 S.Ct. 49, 74 L.Ed. 2d 56 (1982). In ex-

plaining why it was in general agreement with the Court of Appeals decision, the Court reviewed the statutory definition of "first sale",[3] reviewed federal natural gas regulation prior to 1978 (the effective date of the NGPA), considered the history and structure of the NGPA and finally addressed specific arguments raised by the FERC.

In discussing the definition of "first sale" the Court stated the following:

> Under the terms of the general rule, a transfer that falls within any one of its five clauses is presumptively a first sale. This means that there can be many first sales of a single volume of gas between the well and the pipeline's customers. In this case, the downstream transfer plainly satisfies the general rule. The only obstacle to including the intracorporate transfer within the general rule is the question whether it may properly be deemed a "sale."

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[3] NGPA § 2(21) "(A) General rule.—The term 'first sale' means any sale of any volume of natural gas—

(i) to any interstate pipeline or intrastate pipeline;

(ii) to any local distribution company;

(iii) to any person for use by such person;

(iv) which precedes any sale described in clauses (i), (ii), (iii); and

(v) which precedes or follows any sale described in (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this Act." 92 Stat. 3355, 15 U.S.C. § 3301(21)(A).

(B) Certain Sales Not Included.—Clauses (i), (ii), (iii), or (iv) of subparagraph (A) shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, unless such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

> This obstacle, however, is insubstantial. The legislative history clearly demonstrates that the statute was not intended to prohibit the Commission from deeming it a sale; the Conference Committee Report provides that the Commission may "establish rules applicable to intracorporate transactions under the first sale definition." . . . Thus, if the first sale definition consisted only of the general rule, the Commission would plainly be authorized to treat either transfer as a first sale. *Mid-Louisiana*, 103 S.Ct. at 3028, 3029.

The Court did not find § 2(21)(B), which describes certain sales which are excluded from the definition of "first sale," to diminish the FERC's authority to treat either the intracorporate transfer or the downstream transfer as a first sale. After discussing Federal regulation pursuant to the terms of the Natural Gas Act (NGA) prior to 1978 and summarizing the history and structure of the NGPA, the Court noted:

> Several features of this comprehensive scheme bear directly on the question whether Congress intended the Commission to be able to exclude pipeline production from its coverage completely. To begin with, the categories are defined on the basis of the type of well and of the past uses of its gas, not on the basis of who owns the well. And since it is drafted in a manner that is designed to be exhaustive, all natural gas production falls within at least one of the categories. Moreover, the statute replaces the Commission's authority to fix rates of return to gas producers according to what is "just and reasonable" with a precise schedule of price ceilings . . . . The new statutory rates are intended to provide investors with adequate incentives to develope [*sic*] new sources of supply . . . .
>
> Given such a comprehensive scheme, we conclude that Congress would have clearly identified, either in

> the statutory language or in the legislative history, any significant source of production that was intended to be excluded. For the usefulness of natural gas does not depend on who produces it, and there is no reason to believe that any one group of producers is less likely to respond to incentives than any other. Yet nowhere in the NGPA do we find any expression of a desire to exclude pipeline production. *Mid-Louisiana, supra* at 3032-3034.

The Court pointed to the following three statutory provisions which it interpreted as giving a clear signal that Congress intended in the NGPA to include pipeline production within the definition of "first sale":

> 1. Section 203[4] defines the acquisition costs subject to passthrough requirements. Such provision expressly includes pipeline production as a matter subject to NGPA jurisdiction and makes clear that Congress intended to continue a policy in effect since 1938 of drawing no distinction between wells owned by a pipeline itself and those owned by an affiliate.
>
> 2. Section 2(21)(B) requires first sale treatment of a sale that is "attributable to volumes of natural gas produced by such interstate pipeline . . . or any affiliate thereof."
>
> 3. Since pipelines are to be treated in the same fashion as pipeline affiliates and since pipelines' affiliates are expressly covered under the NGPA in Section

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[4] NGPA § 203—Acquisition Costs Subject to Passthrough

(b) —First Sale Acquisition Costs

(2) —Interstate pipeline production. —For purposes of this section, in the case of any natural gas produced by any interstate pipeline or any affiliate of such pipeline, the first sale acquisition cost of such natural gas shall be determined in accordance with rules prescribed by the Commission.

601(b)(1)(E), it follows directly that pipeline production is also covered.

Mid-Louisiana, supra at 3034, 3035.

Next, the Court addressed the following three arguments made by the FERC:

1. It would be wrong to assign the intracorporate transfer a first sale price automatically because not even independent producers receive such automatic treatment.

2. Adoption of the downstream sale theory would result in the application of first sale maximum lawful prices to all mixed volume retail sales by interstate pipelines, intrastate pipelines and local distribution companies, thereby supplanting traditional state regulatory authority over the cost of intrastate pipeline transportation service.

3. Pipeline producers would enjoy an unintended windfall if they received first sale pricing.

First, the Court "completely agreed" that the intracorporate transfer should not automatically receive the NGPA ceiling price and held that Congress "undoubtedly intended pipeline producers to be treated in the same manner as pipeline affiliate producers" who are subject to market control through the application of Section 601(b)(1)(E).[5] *Mid-Louisiana, supra* at 3036.

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[5] NGPA § 601. Coordination with the Natural Gas Act

(b) —Charges Deemed Just and Reasonable

(1) —Sales

(E) —Affiliated Entities Limitation. —For purposes of paragraph (1), in the case of any first sale between any interstate pipeline and any affiliate of such pipeline, any amount paid in any first sale shall be deemed to be just and reasonable if, in addition to satisfying the requirements of such paragraph, such

Second, the Court concluded that the allowance of an appropriate NGPA rate (reflecting gas production costs) in the overall downstream price (which includes transportation and administrative costs) for both comingled [*sic*] gas and non-comingled [*sic*] gas would not trench upon State regulatory authority. The Court saw no difference between the issue of the proper cost to be assigned a pipeline's production efforts and the issue posed when a cost must be assigned to a pipeline's purchase of gas from its producing affiliate, and further concluded that the NGPA effected no special change in the relationship between federal and state regulatory jurisdiction.

Finally, the Court found the FERC's windfall argument to fail when examined in light of Congress' intention in enacting the NGPA. The NGPA replaces FERC authority to determine costs and fix rates of return to gas producers according to what is "just and reasonable" with a precise schedule of price ceilings. *Mid-Louisiana*, *supra* at 3033.

"The NGPA was the product of a Conference Committee's careful reconciliation of two strong, but divergent, responses to the natural gas shortage." In the 1970's "interstate rates remained substantially below the unregulated prices available for intrastate sales, and the interstate supply remained inadequate." *Mid-Louisiana*, *supra* at 3031. It could be surmised that the existence of the dual market was prompted by pressures from producing (net exporting) states for higher prices and pressures from the larger and politically influential nonproducing (net importing) states to maintain their cost for gas at a minimum. The NGPA did not destroy the dual market setting but merely reversed the pricing disparity by setting maximum ceiling prices for the "first

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amount does not exceed the amount paid in comparable first sales between persons not affiliated with such interstate pipeline.

sale" of natural gas and allowed gas producing states to set prices at or below the maximum.

Like the Court of Appeals, the Court concluded that the FERC's exclusion of pipeline production from "first sale" treatment was "inconsistent with the statutory mandate [and would] frustrate the policy that Congress sought to implement." *Mid-Louisiana, supra* at 3037.

B. *FERC Response to Mid-Louisiana Decision*

The definition of "first sale" as set forth in § 2(21) of the NGPA and in FERC Order 58 specifically applies to sales of any volume of natural gas to any interstate pipeline, intrastate pipeline or to any local distribution company. Insofar as this Commission is concerned, Pennzoil is a local distribution company as defined in § 2(17) of the NGPA.[6] As hereinbefore discussed, the Supreme Court has determined that FERC exclusion of pipeline production from first sale treatment either at the intracorporate transfer or at the downstream transfer is inconsistent with the NGPA's statutory mandate and would frustrate the policy that Congress sought to implement.

In response to the Supreme Court's decision in *Mid-Louisiana*, the FERC initiated a proposed rulemaking on December 28, 1983, establishing the point of first sale treatment for interstate pipelines at the intracorporate transfer, which it deemed to occur at the wellhead. In discussing its proposed rule with regard to intrastate sales, the FERC stated the following:

> This notice of proposed rulemaking proposes to define the point of first sale for gas subject to § 2(21) of the NGPA. This Section includes production by interstate and intrastate pipelines, distributors and their affiliates. While the proposed definition in

[6] NGPA § 2(17)—The term "local distribution company" means any person, other than any interstate pipeline or any intrastate pipeline, engaged in the transportation, or local distribution, of natural gas and the sale of natural gas for ultimate consumption.

> § 271.103(a) mentions intrastate and interstate pipelines, distributors, and their affiliates due to the scope of § 2(21) of the NGPA, all other proposals implement regulations only for interstate pipelines. Even though the Commission might be viewed as having some authority to extend certain elements in these regulations (such as determining the intracorporate transfer as the point of first sale) to intrastate enities, [*sic*] the Commission does not have jurisdiction over the rates that a intrastate pipeline or distributor charges its customers. Thus, the Commission regards the issue of how an intrastate entity should be allowed to price the gas it resells (at the NGPA ceiling rates or otherwise) as one that remains within the providence of State regulatory agencies.
>
> *Notice of Proposed Rule Making*, Docket Nos. RM83-72 and RM82-16 (1983).

The FERC's interpretation of the attribution requirements of a first sale (NGPA § 2(21)(B)) as contained in FERC Order No. 58, has been struck down by the Supreme Court. Therefore, this Commission's reliance thereon in its September 10, 1981 Decision in this case must also fall. The Supreme Court has determined that § 2(21) of the NGPA requires the FERC to accord interstate pipelines first sale treatment for their own gas production either as an intracorporate transfer or a downstream transfer.

Assuming that the FERC pursues to completion its rulemaking proceeding which establishes the point of first sale for interstate pipelines at the intracorporate transfer (wellhead), the issue of how an intrastate entity should be allowed to price the gas it resells will be left to the State regulatory agencies to determine. This Commission would then determine the point of first sale at either the intracorporate transfer or the downstream transfer.

C. *Commission Authority to Price Pennzoil's Produced Gas on a Cost of Service or Other Basis*

The West Virginia Legislature in *W.Va. Code* § 24-1-1 *et seq.* endowed the Commission with the authority and duty to enforce and regulate the practices, services and rates of public utilities in order to ensure that rates and charges for utility services are just, reasonable, applied without unjust discrimination or preference and based primarily on the cost of providing these services. Further, *Code* § 24-2-2 provides in part that in no case shall the rate, toll or charge be more than the service is reasonably worth, considering the cost thereof. Historically, this Commission has established the price for Pennzoil's own gas production as close as possible to cost. Both in Case No. 9025 (1978) and in Case No. 79-145-G-42T (1980), the Commission used an Independent Oil and Gas Association (IOGA) federally approved rate as a proxy for cost in determining a just and reasonable rate. Again in this case, the Commission used an IOGA rate as a beginning point in its calculation of a just and reasonable rate to represent Pennzoil's cost of producing gas in West Virginia. However, as stated by the Supreme Court in *Mid-Louisiana*, all natural gas production falls within at least one of the categories set forth in the NGPA, i.e. all gas has a first sale. Later in its decision the Court stated that the NGPA effects no special change in the relationship between Federal and State regulatory jurisdiction, footnoting to the Court's decision in *Exxon Corporation v. Eagerton*, —— U.S. ——, ——, 103 S.Ct. 2296, 2303, 75 L.Ed. 2d —— (1983), for the proposition that § 105(a) of the NGPA extended Federal authority to control producer prices to the intrastate market, but at the same time § 602(a) allows the States to establish price ceilings for the intrastate market that are lower than the Federal ceiling.[7] The Court also cited a prior

[7] § 602 EFFECT ON STATE LAWS.

(a) Authority to prescribe lower maximum lawful prices. —Nothing in this Chapter shall affect the authority of any

decision stating that by enacting the NGPA, "Congress explicitly envisioned that the States would regulate intrastate markets in accordance with the overall national policy". See *Energy Reserves Group, Inc. v. Kansas Power and Light Company*, —— U.S. ——, —— 103 S. Ct. 697, 710, 74 L.Ed. 2d 569 (1983).

Thus § 602(a) of the NGPA clothes the Commission with the authority to establish a maximum lawful price for the first sale of Pennzoil's own gas production based upon cost of service pricing. As hereinbefore set forth, the Commission's ratemaking authority under Chapter 24 of the West Virginia Code pre-existed the enactment of the NGPA[8]

To carry out the holding of the Supreme Court in *Mid-Louisiana* as relevant to this case, this Commission is compelled to find that Pennzoil's own gas production in

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State to establish or enforce any maximum lawful price for the first sale of natural gas produced in such State which does not exceed the applicable maximum lawful price, if any, under Title I of this Act.

[8] In previous argument before the Commission, Pennzoil contended that absent a designation by the Governor, *Code* § 24-2-13 did not enable the Commission to exercise the State's power under § 602(a). However, there is no necessity for the Governor to designate the Commission as the responsible agency for cost of service pricing under § 602(a) of the NGPA. The language in *Code* § 24-2-13 which refers to the designation by the Governor of the Commission as the responsible agency for carrying out "appropriate portions of the Natural Gas Policy Act of 1978" applies to specific provisions of the NGPA which require State action and which do not clearly fall under the responsibility of a particular agency. For instance, the role of the Oil & Gas Division of the Department of Mines in certifying well classifications under the NGPA is specifically contemplated under the Act. If the Governor should decide to shift such responsibility from the Oil & Gas Division to this Commission, it would necessitate a specific designation. Further, this Commission has previously carried out the responsibilities of Title II of the NGPA through incremental pricing proceedings without any specific designation by the Governor.

West Virginia, which is used for Pennzoil's utility purposes, constitutes a first sale of gas. Furthermore, the Court in *Mid-Louisiana* acknowledged that Congress, through the provisions of § 602(a) of the NGPA, recognized that the various States have the authority to establish maximum lawful prices for a first sale lower than the ceiling prices contained within the NGPA. Section 602(a) specifically provides that "nothing in this chapter shall *affect* the authority of any State. . . ." (Emphasis added). Since the Commission's authority to establish a just and reasonable price to be included in Pennzoil's cost of service for the recovery of the cost for its own gas production in West Virginia has not been "affected" by the enactment of the NGPA, there exists no valid reason why the Commission cannot continue to do so.

Thus, under § 602(a) the Commission, in establishing a just and reasonable price to be included in Pennzoil's cost of service for its own produced gas, should look to the actual cost of such production, which includes a reasonable return on investment, or, in the absence of such evidence, should look to other transactions to establish a proxy for such cost.

The NGPA compels this conclusion even if § 602 did not apply. While the NGPA and *Mid-Louisiana* tell us that the Pennzoil gas is subject to first sale treatment, just as pipeline production is, neither pipeline production nor Pennzoil's production is entitled to the full maximum lawful ceiling rate automatically. Paraphrasing the Supreme Court in *Mid-Louisiana*, just as Congress "undoubtedly intended pipeline producers to be treated in the same manner as pipeline affiliate producers" who are subject to market control through the application of § 601(b)(1)(E), so too must Congress have intended local distribution company producers to be treated in a similar manner, by subjecting them to an "affiliated entities limitation" test. This too suggests that Pennzoil should be allowed to recover for its gas an amount which "does not

exceed the amount paid in comparable first sales between parties not affiliated" with Pennzoil. NGPA § 601(b)(1)(E); *Mid-Louisiana, supra* at 3036.

Accordingly, we hold that this Commission has the authority under § 602(a) of the NGPA to determine a just and reasonable price to be included in Pennzoil's rates for the recovery of the cost of its own production in West Virginia either by using a production cost of service study or by any other reasonable means, including a proxy for such cost of service.

Further, even if § 602(a) did not apply, we hold that Congress must have intended local distribution company producers such as Pennzoil to be bound by an "affiliated entities limitation" such as set out in § 601(b)(1)(E).

However, in this case, as discussed on pages 15 to 17 of the Commission's September 10, 1981 decision, there is insufficient evidence before the Commission to establish a price for Pennzoil's own gas production on the basis of a direct production cost of service study. Thus, a proxy for cost will again have to be utilized in determining a just and reasonable price for Pennzoil's own West Virginia gas production.

We believe that the method employed by the Commission in its September 10, 1981 order to arrive at the § 1.773 per Mcf as Pennzoil's reasonable production and gathering costs is a reasonable proxy for an acceptable cost of service study. However, upon reconsideration we now believe that an evaluation of wellhead prices received by other producers in Pennzoil's service area is more appropriate for the purposes of this case. The method is preferable for two reasons. First, the Commission has used this method in recent prior cases. Furthermore, our review of the NGPA and the Court's *Mid-Louisiana* decision lead us to conclude that an "affiliated entities limitation" similar to § 601(b)(1)(E) of the NGPA is applicable even if the Commission did not have the author-

ity granted to it pursuant to § 602(a). Therefore, even though we have the authority to evaluate Pennzoil's costs to arrive at a applicable allowable rate for Pennzoil's own production, since we have no reliable cost study as evidence we can apply a comparable purchase proxy for cost in this case. It is noted that a careful reading of § 601(b)(1)(E) can lead to the logical conclusion that ". . . comparable first sales *between* persons not affiliated . . ." refers to transactions involving both a buyer and seller which are not affiliated with Pennzoil. To look only to Pennzoil's purchases from non-affiliates for meeting the § 601(b)(1)(E) limitation could be a disincentive to Pennzoil's efficient acquisition of the lowest cost non-affiliated gas. However, since we are dealing with an historic locked in period in this case covering a period before all producers availed themselves of NGPA maximum lawful ceiling prices, we shall utilize Pennzoil's purchase from non-affiliates to price its own production in this case.

Having decided to look to Pennzoil's purchases from non-affiliates to price its own production, we must determine the per unit costs of such purchases to be applied in this case. Although under normal circumstances, we would be setting Pennzoil's rates prospectively, based on test year cost levels, because of the circumstances of this case we are dealing with a past locked in period from October 8, 1980 to October 13, 1982, the date that the rates herein established were superceded by Case No. 82-086-G-42T. Therefore, we believe that it would be reasonable for the purposes of this case only to price Pennzoil's production during the locked in period at the wellhead price paid by Pennzoil to non-affiliated suppliers during the same period. Since we will provide for Pennzoil's own gathering cost at 61¢ per Mcf and production taxes at 8.63%, the producer price utilized should exclude any gathering allowance and production taxes. The record does not contain the level of Pennzoil's purchases from non-affiliates during the full locked in

period of this case; therefore we shall order Pennzoil to recalculate its allowable cost of service by substituting its average purchase price, less gathering and production tax allowances, during the appropriate period.

FINDINGS OF FACT

The Commission is of the opinion and finds that:

1. The Commission's September 10, 1981 decision in this case established a price for the cost of Pennzoil's own West Virginia produced gas sold to its West Virginia utility customers in reliance upon the FERC's interpretation of the "first sale" requirements of § 2 (21) (A) and (B) of the NGPA as set forth in FERC Order No. 58.

2. The U.S. Supreme Court has affirmed the Court of Appeals decision[9] holding that FERC Order No. 58 is invalid.

3. The Commission's September 10, 1981 determination of just and reasonable price to include in Pennzoil's cost of service for the recovery of the cost of its own West Virginia gas production based upon the failure of such gas to qualify as a "first sale" under the provisions of the NGPA has been struck down.

4. The Supreme Court has held that FERC was required, not just permitted, to accord first sale treatment to pipeline production either at the wellhead or downstream. In so doing, it interpreted Sections 2(20) and 2(21)(A) and (B) which cover transactions by interstate and intrastate pipelines and local distribution companies.

5. Nothing in *Mid-Louisiana* suggests that the Supreme Court's interpretation of first sale for an inter-

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[9] *Mid-Louisiana Gas Co. v. Federal Energy Regulatory Commission*, 664 F.2d 530 (5th Cir. 1981).

state pipeline should not also apply to intrastate pipelines and local distribution companies.

6. These facts, plus the fact that the Supreme Court remanded *Pennzoil* to be considered in light of *Mid-Louisiana*, compel the conclusion that the Pennzoil intracorporate transfer should be accorded first sale treatment.

CONCLUSIONS OF LAW

The Commission is of the opinion and concludes that:

1. As a result of the Supreme Court's decision in *Mid-Louisiana*, this Commission is compelled to find that Pennzoil's own gas production in West Virginia, which is used for utility purposes, constitutes a first sale of gas.

2. Congress, through the provision of § 602(a) of the NGPA, recognized that the various States have the authority to establish maximum lawful prices for a first sale of natural gas lower than the ceiling prices contained within the NGPA. Section 602(a) specifically provides that "nothing in this chapter shall *affect* the authority of any State . . ." to so establish such prices.

3. Since the Commission's authority to establish a just and reasonable price to be included in Pennzoil's cost of service for the recovery of the cost for its own gas production in West Virginia has not been "affected" by the enactment of the NGPA, there exists no valid reason why the Commission cannot continue to price Pennzoil's West Virginia gas production on a cost of service basis.

4. Even if § 602(a) did not apply, Pennzoil's gas production is not entitled to the full maximum lawful ceiling rate of the NGPA automatically. *Mid-Louisiana*, 103 S.Ct. at 3036.

5. Just as Congress undoubtedly intended pipeline producers to be treated in the same manner as pipeline affiliate producers, by making any intracorporate transfers subject to the "affiliated transaction limitation" test

in § 601(b)(1)(E), so too must Congress have intended local distribution company producers to be treated in a similar manner. *Mid-Louisiana*, *supra* at 3036.

6. There is insufficient evidence before the Commission in this case to establish a price for Pennzoil's own gas production on a cost of service basis. Thus, a proxy for cost will again have to be utilized in determining a just and reasonable price for Pennzoil's own West Virginia gas production.

7. The Commission concludes that the price Pennzoil was paying its independent producers for gas during the period the rates in this case were effective is appropriate, just, reasonable and lawful and should be included in Pennzoil's cost of service as the allowances for its own produced gas.

ORDER

1. The rates and charges contained in the Fourth Revision of Original Sheet No. 14 of P.S.C. W.VA. No. 1, are unreasonable and unjust in that they do not generate sufficient revenue for Pennzoil to pay its reasonable and necessary operating expenses, to pay its taxes, to earn a fair rate of return on investment, and to finance necessary capital improvements.

2. The rates and charges contained in Fifth Revised Sheet No. 14 of P.S.C. W.VA. No. 1 and placed into effect, subject to refund, on or about October 8, 1980, are unreasonable and excessive in that they will generate revenue in excess of that needed for the purposes set forth in paragraph 1.

3. The rates and charges set forth in Appendix B attached to the Hearing Examiner's decision of February 17, 1981, are unreasonable and unjust because (1) they do not reflect a just and reasonable price per Mcf for Pennzoil to collect from its retail customers for the Company's own produced gas, (2) they do not reflect a just

and reasonable price per Mcf for the Company's purchased gas (see Footnote No. 1 of our September 10, 1981 order), and (3) they do not accurately reflect the Hearing Examiner's decision regarding interest expense.

4. The rates and charges set forth in Appendix B, attached to our September 10, 1981 decision, are to be modified to reflect Pennzoil's purchase from non-affiliates, exclusive of gathering and tax allowances, in place of the $1.01 cost level utilized by Commission in that order.

5. The Respondent, Pennzoil Company, shall within thirty (30) days of the date of this order file a recalculated cost of service and tariffs for Commission approval containing the costing methodology for the relevant period as herein set forth.

6. The Respondent shall refund to each of its customers within sixty (60) days from the date of Commission approval of its rates filed pursuant to ordering paragraph (4) the difference between the amounts collected under Fifth Revised Sheet No. 14 of P.S.C. No. 1, and the rates and charges hereafter approved, with interest at the rate of fourteen percent (14%) per annum for the period beginning October 8, 1980 to the date of refund. Refunds of five dollars ($5.00) or less due existing customers may be made by crediting the amount to the customer's account. Refunds of five dollars ($5.00) or less due former customers shall be made by check. Refunds in excess of five dollars ($5.00) shall be made by check unless the customer's account is past due, in which case the refund may be credited to the account to the extent of said past due balance. The Company shall report to the Commission, within thirty (30) days of completing the refund, the amount refunded, the manner of refund, and the amount, if any, which it has been unable to refund.

7. The Executive Secretary is hereby ordered to serve a copy of this order upon the Commission Staff by hand

delivery, and upon all parties of record by United States Certified Mail, return receipt requested.

A TRUE COPY

TESTE:

/s/ Howard M. Cunningham,
HOWARD M. CUNNINGHAM,
Executive Secretary

Commissioner Casto did not participate in this decision.

APPENDIX C

STATE OF WEST VIRGINIA

At a Regular Term of the Supreme Court of Appeals continued and held at Charleston, Kanawha County, on the 13th day of September, 1984, the following order was made and entered, to-wit:

PENNZOIL COMPANY, a corporation,
Petitioner

vs.

THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA,
Respondent

On a former day, to-wit, September 10, 1984, came the Pennzoil Company, a Corporation, by Goodwin & Goodwin and C. E. Goodwin, John B. Chapman, Baker & Botts, Bruce F. Kiely and Kirk K. Van Tine, its attorneys, and presented to the Court its motion in writing for leave to file a petition for rehearing of the Court decision remanding this proceeding to the Public Service Commission, tendering its petition for rehearing therewith, which motion being seen and inspected by the Court is refused.

A True Copy

Attest:

/s/ George W. Singleton
Clerk Supreme Court of Appeals

APPENDIX D

STATUTES

Natural Gas Policy Act of 1978,
Section 601(b), 15 U.S.C. § 3431(b).

SEC. 601. COORDINATION WITH THE NATURAL GAS ACT.

. . .

(b) CHARGES DEEMED JUST AND REASONABLE.—

(1) SALES.—

(A) FIRST SALES.—Subject to paragraph (4), for purposes of sections 4 and 5 of the Natural Gas Act, any amount paid in any first sale of natural gas shall be deemed to be just and reasonable if—

(i) such amount does not exceed the applicable maximum lawful price established under title I of this Act; or

(ii) there is no applicable maximum lawful price solely by reason of the elimination of price controls pursuant to subtitle B of title I of this Act.

(B) EMERGENCY SALES.—For purposes of sections 4 and 5 of the Natural Gas Act, any amount paid in any sale authorized under section 302(a) shall be deemed to be just and reasonable if such amount does not exceed the fair and equitable price established under such section and applicable to such sale.

(C) SALES BY INTRASTATE PIPELINES.—For purposes of sections 4 and 5 of the Natural Gas Act, any amount paid in any sale authorized by the Commission under section 311(b) shall be

deemed to be just and reasonable if such amount does not exceed the fair and equitable price established by the Commission and applicable to such sale.

(D) ASSIGNMENTS.—For purposes of sections 4 and 5 of the Natural Gas Act, any amount paid pursuant to the terms of any contract with respect to that portion of which the Commission has authorized an assignment authorized under section 312(a) shall be deemed to be just and reasonable if such amount does not exceed the applicable maximum lawful price established under title I of this Act.

(E) AFFILIATED ENTITIES LIMITATION.—For purposes of paragraph (1), in the case of any first sale between any interstate pipeline and any affiliate of such pipeline, any amount paid in any first sale shall be deemed to be just and reasonable if, in addition to satisfying the requirements of such paragraph, such amount does not exceed the amount paid in comparable first sales between persons not affiliated with such interstate pipeline.

Natural Gas Policy Act of 1978
Section 602, 15 U.S.C. § 3432.

SEC. 602. EFFECT ON STATE LAWS.

(a) AUTHORITY TO PRESCRIBE LOWER MAXIMUM LAWFUL PRICES.—Nothing in this Act shall affect the authority of any State to establish or enforce any maximum lawful price for the first sale of natural gas produced in such State which does not exceed the applicable maximum lawful price, if any, under title I of this Act.

(b) COMMON CARRIERS.—No person shall be subject to regulation as a common carrier under any provision of Federal or State law by reason of any transportation—

(1) pursuant to any order under section 302(c) or section 303(b), (c), (d), or (i) of this Act; or

(2) authorized by the Commission under section 311(a) of this Act.

APPENDIX E

—— U.S. ——, 103 S. Ct. 3564

UNITED STATES SUPREME COURT

No. 81-1672

PENNZOIL COMPANY,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF WEST VIRGINIA

Former decision, 456 U.S. 959, 102 S. Ct. 2033.

July 6, 1983. On petition for writ of certiorari to the Supreme Court of Appeals of West Virginia. The petition for writ of certiorari is granted. The judgment is vacated and the case is remanded to the Supreme Court of Appeals of West Virginia for further consideration in light of *Public Service Commission of the State of New York v. Mid-Louisiana Gas Company,* 463 U.S. ——, 103 S. Ct. 3024, 76 L.Ed. 2d —— (1983).

APPENDIX F

REGULATIONS

§ 270.203 PIPELINE, DISTRIBUTOR, AND AFFILIATE PRODUCTION.

(a) *General rule.* The definition of first sale in section 2(21) of the NGPA includes gas produced by an interstate pipeline, intrastate pipeline, local distribution company, or any affiliate thereof.

(b) *Intracompany transfer.*—(1) *First sales by interstate pipelines.* A transfer, at the wellhead, of gas produced by an interstate pipeline company's production divisional unit to its transmission divisional unit is that pipeline's first sale under the NGPA. It must be evidenced in an intracompany operating statement.

(2) *First sales by intrastate pipelines.* A transfer, at the wellhead, of gas produced by an intrastate pipeline company's production divisional unit to its transmission divisional unit is that pipeline's first sale under the NGPA.

(3) *First sales by a local distribution company.* A transfer, at the wellhead, of gas produced by a local distribution company's production divisional unit to its transmission divisional unit is that company's first sale under the NGPA.

(c) *Circumvention rule for certain sales by affiliates.* Any sale by an affiliate of an interstate pipeline, intrastate pipeline, or local distribution company, that is not itself such a pipeline or local distribution company is that affiliate's first sale under the NGPA unless the Commission, on application, determines not to treat such sale as a first sale.